



FEDERAL ELECTION COMMISSION
WASHINGTON, D C 20463

AUG 24 2004

Tim Shaw, General Manager
Community Water System, Inc.
Higden, AR 72067

RE: MUR 5514
Community Water System, Inc.

Dear Mr. Shaw:

On August 12, 2004, the Federal Election Commission found that there is reason to believe Community Water System, Inc. knowingly and willfully violated 2 U.S.C. §§ 441b(a) and 441f, provisions of the Federal Election Campaign Act of 1971, as amended ("the Act"). The Factual and Legal Analysis, which formed a basis for the Commission's finding, is attached for your information.

You may submit any factual or legal materials that you believe are relevant to the Commission's consideration of this matter. Please submit such materials to the General Counsel's Office within 15 days of your receipt of this letter. Where appropriate, statements should be submitted under oath. In the absence of additional information, the Commission may find probable cause to believe that a violation has occurred.

Requests for extensions of time will not be routinely granted. Requests must be made in writing at least five days prior to the due date of the response and specific good cause must be demonstrated. In addition, the Office of the General Counsel ordinarily will not give extensions beyond 20 days.

- If you intend to be represented by counsel in this matter, please advise the Commission by completing the enclosed form stating the name, address, and telephone number of such counsel, and authorizing such counsel to receive any notifications and other communications from the Commission.

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For your information, we have enclosed a brief description of the Commission's procedures for handling possible violations of the Act. If you have any questions, please contact Roy Q. Luckett, the attorney assigned to this matter, at (202) 694-1650.

Sincerely,

Bradley A. Smith
Chairman

Designation of Counsel Form

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FEDERAL ELECTION COMMISSION
FACTUAL AND LEGAL ANALYSIS

RESPONDENT: Community Water System, Inc.

MUR 5514

I. GENERATION OF MATTER

This matter was generated based on information ascertained by the Federal Election Commission ("the Commission") in the normal course of carrying out its supervisory responsibilities. *See* 2 U.S.C. § 437g(a)(2).

II. THE APPLICABLE LAW

The Federal Election Campaign Act of 1971, as amended ("the Act") prohibits corporations from making contributions or expenditures from their general treasury funds in connection with a federal election. 2 U.S.C. § 441b(a). In addition, this section prohibits any officer or director of a corporation from consenting to any such contribution or expenditure. *Id.* Section 441(b) also makes it unlawful for any candidate, political committee or any other person knowingly to accept or receive corporate contributions. The Act also provides that no person shall make a contribution in the name of another person or knowingly permit his or her name to be used to effect such a contribution, and that no person shall knowingly accept a contribution made by one person in the name of another person. 2 U.S.C. § 441f. In addition, no person may

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knowingly help or assist any person in making a contribution in the name of another.

11 C.F.R. § 110.4(b)(1)(iii).¹ This prohibition also applies to persons or entities who provide money to others to effect contributions made in another's name. 11 C.F.R. § 110.4(b)(2).

The Act penalizes more heavily violations that are knowing and willful. 2 U.S.C. §§ 437g(a)(5)(B), (6)(c), and (d)(1). To be liable for a knowing and willful violation, respondents must act with the knowledge that they are violating the law. *Federal Election Commission v. John A. Dramesi for Congress Committee*, 640 F. Supp. 985, 987 (D.N.J. 1986). An inference of a knowing and willful act may be drawn "from the defendant's elaborate scheme for disguising" his or her actions. *United States v. Hopkins*, 916 F.2d 207, 214-15 (5th Cir. 1990).

III. FACTS AND ANALYSIS

A. Shelly Davis' Memorandum

Information in the Commission's possession alleges that CWS may have reimbursed campaign contributions to multiple federal campaigns through company payments of fraudulent invoices, or other reimbursement vehicles, to conduits who were outside vendors to CWS. According to a December 3, 2002 memorandum to CWS board members from Shelly Davis, administrative assistant to former Community Water System, Inc. ("CWS") General Manager

¹ This regulation "applies to those who initiate or instigate or have some significant participation in a plan or scheme to make a contribution in the name of another . . ." 54 Fed. Reg. 34,105 (1989). In *Central Bank of Denver v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994), the Supreme Court held that private plaintiffs could not maintain an aiding and abetting action under section 10(b) of the Securities and Exchange Act of 1934 or Rule 10b-5 thereunder because the text of § 10(b) did not provide for aiding and abetting liability. This ruling, however, does not affect the validity of 11 C.F.R. § 110.4(b)(1)(iii), which arguably goes beyond the text of 2 U.S.C. § 441f in imposing liability for assisting in making contributions in the name of another. The *Central Bank* opinion did not address an agency's authority to promulgate prophylactic rules, which commonly enlarge the scope of the statute; indeed, the Court upheld the Security and Exchange Commission's authority to promulgate such a rule in a post-*Central Bank* decision. *US v. O'Hagan*, 521 U.S. 642, 673 (1997). Imposing liability on those who assist in making contributions in the name of another through 11 C.F.R. § 110.4(b)(1)(iii) also serves a prophylactic purpose.

Greg Smith, Ms. Davis notes that she became aware of alleged political contribution reimbursements in 1998:

Ms. Davis' memorandum further maintains that the reimbursement scheme continued in 2000. She states that Preston Bynum allegedly called Greg Smith again in order to set up a fundraiser for Congressman Berry in September. According to Ms. Davis, "Once again Greg made his phone calls and instructed the individuals to handle as before."

Although Ms. Davis' memorandum refers generally to multiple individuals who were instructed to contribute with the expectation of reimbursement, she fully identifies by name only attorney Heartsill Ragon III of Gill Elrod Ragon Owen & Sherman P.A. ("Gill Law Firm"), who provided legal services to CWS.³ An October 29, 2000 invoice, on Gill Law Firm letterhead, to

² According to published accounts, in 1998 CWS General Manager Greg Smith hired Preston Bynum, a recently released felon convicted of bribery and perjury charges, as a lobbyist to help CWS secure federal and state funding for the Lonoke-White Project. See Elisa Crouch, *Waterline Project Beset by Conflicts over Management*, The Arkansas Democrat Gazette, March 2, 2003. The Lonoke-White Project is a pipeline expected to pump water from Greers Ferry Lake to six water systems in Lonoke and White counties in Arkansas, reaching more than 16,000 customers. *Id.*

³ According to Dun and Bradstreet reports, the Gill Law Firm has been incorporated since 1994. Heartsill Ragon III is listed as a Vice President of the firm.

CWS contains a "miscellaneous" expense on October 11, 2000 in the amount of \$1,000.⁴

According to Ms. Davis' memorandum, Greg Smith allegedly instructed CWS's controller to refrain from paying the invoice until the expense was identified. A CWS employee allegedly contacted the Gill Law Firm and was informed by Mr. Ragon that the "miscellaneous" expense represented reimbursement of a political contribution. Mr. Ragon reportedly also stated that Mr. Smith had instructed him to classify the political contribution reimbursement as "miscellaneous."⁵ The Commission's copy of the October 29, 2000 invoice is accompanied by handwritten notes, appearing on the right side, reportedly reading "Political contribution. Greg told Heartsill to charge it."⁶ Ms. Davis' memorandum states that "[t]hese contributions are being made, the invoices submitted for payment. Greg approves them for payment out of Federal Grant Funds and then he collects 3% of the expense."⁷

⁴ Ms. Davis' memorandum appears to state that the "miscellaneous" expense was \$2,000. However, the invoice is for only \$1,000.

⁵ Ms. Davis suggests in her memorandum that Mr. Ragon spoke to CWS employee Jennifer Fife directly, but Ms. Fife's recollection, as reported in the press, was that she spoke to Mr. Ragon's secretary. See Elisa Crouch, *Waterline Project Beset by Conflicts over Management*, The Arkansas Democrat Gazette, March 2, 2003.

⁶ Although the handwritten notes are not clearly visible, the CWS employee who contacted Mr. Ragon's office reportedly identified the handwriting as her own, and described the content of her notes in a press interview. See Elisa Crouch, *Waterline Project Beset by Conflicts over Management*, The Arkansas Democrat Gazette, March 2, 2003.

⁷ Elsewhere in Ms. Davis' memorandum, she alleges that Economic Development of Arkansas Fund Commission ("EDAFC") grant funds were used to pay fraudulent expenses. It is possible that EDAFC had a funding arrangement with the federal government. According to published reports, the EDAFC awarded funds to the Lonoke-White Project, which would in turn distribute funds to CWS. See Sonja Oliver, *CWS audit report*, Fairfield Bay News, March 12, 2003. CWS would acquire the EDAFC funds as a reimbursement for expenses paid by CWS's own operating funds. *Id.* Additionally, according to published reports, in 1999 Greg Smith formed Cenark Management Services Inc. ("Cenark"), a corporation that CWS hired to manage the Lonoke-White Project. *Id.* According to the terms of the contract between CWS and Cenark, Cenark received 3% of the cost of the Lonoke-White Project as its fee for management services on behalf of CWS. *Id.* Therefore, if CWS reimbursed political contributions, and these were reflected as costs of the Lonoke-White Project, CWS would be reimbursed by grant funds and Cenark would receive 3% of the costs of the project.

Ms. Davis also makes an oblique reference to a second potential 2000 conduit, a "Charlie" whose "2000 contribution was delayed," which "caused him some problems." The Commission believes this may refer to Charles McLaughlin. E-mail correspondence regarding the making of political contributions, included in information in the Commission's possession, shows that Greg Smith addressed Charles McLaughlin by the nickname "Charlie," and Mr. McLaughlin made political contributions to Congressman Berry and others in 2000 and 2002. Moreover, Dun and Bradstreet reports identify Mr. McLaughlin as the President of McLaughlin Engineering, Inc., a company that appears to have worked with CWS on matters concerning the Lonoke-White Project. *See Elisa Crouch, Waterline Project Beset by Conflicts over Management, The Arkansas Democrat Gazette, March 2, 2003.* Under these circumstances, the Commission believes there is a permissible inference that "Charlie" is in fact Charles McLaughlin.

According to Ms. Davis' memorandum, CWS engaged in political contribution reimbursement activity in 2002 in connection with an August 9, 2002 fundraiser for Congressman Berry and an August 15, 2002 fundraiser for Senator Hutchinson. CWS allegedly reimbursed Heartsill Ragon III and "Charlie" (McLaughlin) for contributions made to the campaigns of Congressman Berry and Senator Hutchinson. Ms. Davis states that, owing to the delay in "Charlie" receiving reimbursement for his 2000 contribution, Mr. Smith requested that Mr. Ragon and "Charlie" send their invoices before the contributions were actually made:

The Commission also possesses a copy and a "corrected" copy of Gill Law Firm invoices dated July 29, 2002 and an invoice purportedly revised dated August 29, 2002. The original July 29, 2002 invoice includes an entry for \$2,000 described as "miscellaneous reimbursements." The "corrected" July 29, 2002 invoice reflects a change in the description of the \$2,000 in expenses from "miscellaneous reimbursements" to "series of intraoffice conferences re: various long-term planning, finance and operational issues."⁸ The August 29, 2002 invoice has an entry for 15.40 hours of legal services for "series of intraoffice conferences re: various long-term planning, finance and operational issues."⁹ At an indicated rate of \$130 per hour, this entry represents a request by the Gill Law Firm for payment of \$2,002.

According to Ms. Davis, Mr. Smith had directed Heartsill Ragon III to change the descriptions in the invoices. In her memorandum, Ms. Davis recounts Mr. Smith's alleged discussion with Mr. Ragon about revising the invoices:

Thereafter, Ms. Davis describes her efforts to gather additional evidence of the alleged reimbursement scheme. Ms. Davis states that while Mr. Smith was out of the office, she e-mailed Mr. Ragon and requested that he refax the invoices to her and he did so.

⁸ Although the Commission does not know the actual date that the amended invoice was submitted, the written notes (author unknown) on the invoice suggest that CWS received it on October 2, 2002.

⁹ The information in the Commission's possession does not include a prior August 2002 invoice with the entry "miscellaneous reimbursements."

Mr. Ragon's response to Ms. Davis's e-mail, which the Commission possesses, states "Shelly, thanks for the note. I'll refax. I've taken out the 'extra' \$1,000 charge. Thanks...H."

The Commission is also in possession of a December 4, 2002 e-mail from Ms. Davis, which appears to be directed to CWS board member Barbara Sullivan.¹⁰ According to that e-mail, Ms. Davis eventually confronted Mr. Smith regarding the alleged conduit contribution scheme, stating:

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In addition, this apparently was not the first time Ms. Davis had apprised personnel of CWS of the alleged reimbursement scheme. Ms. Davis states in her memorandum that she had apprised individual board members in August 2002.

¹¹ In both the December 3, 2002 memorandum and December 4, 2002 e-mail, Ms. Davis alleges that Mr. Smith accused her of leaking the reimbursement scheme to CWS's Board and retaliated against her by removing duties from her. According to both communications, Ms. Davis decided to seek legal counsel.

It is possible that Ms. Davis' alleged confrontation with Mr. Smith led him to contact the Gill Law Firm concerning her allegations. A November 21, 2002 memorandum from Heartsill Ragon III to Greg Smith addresses the Gill Law Firm's refund of \$4,002 in legal fees included in its July and August 2002 invoices, and suggests that questions had been raised about the services noted in these invoices.

On December 16, 2002, CWS reportedly dismissed Greg Smith and terminated its working relationship with the Gill Law Firm, reportedly noting in a file memorandum that Mr. Smith's activities on behalf of CWS appeared to involve illegal contributions to political candidates and the falsification of records.¹² Further, CWS board member Barbara Sullivan has stated in press accounts that she expects the full scope of the reimbursement scheme to reach at least \$20,000 in reimbursed contributions. *See Bert King, Water Chief Fired Due to Dereliction, The Cabot Star Herald, January 8, 2003.* Both Mr. Smith and the Gill Law Firm reportedly have maintained their innocence; Mr. Smith and CWS currently are embroiled in two separate lawsuits (wrongful termination and breach of contract) growing out of the allegations in this matter.¹³

B. Analysis

Ms. Davis' memorandum and the related information describe a corporate reimbursement scheme during 2002 that, if proven, would constitute violations of 2 U.S.C. §§ 441b(a) and 441f by CWS through its agent, former General Manager Greg Smith. Under well-settled principles

¹² *See Christine Weiss, CWS memo cites 'illegal acts' leading to firing, The Heber Springs Sun-Times, January 3, 2003.*

¹³ *See Sonja Oliver, CWS board still facing lawsuits, The Heber Springs Sun-Times, December 24, 2003.* In February 2003, following Smith's termination, CWS reportedly dissolved its contract with Cenark. *See Michelle Hillen, Lawsuits fly: Fired utility chief, water system toe-to-toe Pipeline conflict of interest cited, The Arkansas Democrat Gazette, July 1, 2003.* Mr. Smith reportedly lost approximately \$1.3 million in Cenark fees due to the contract dissolution. *Id.* On December 23, 2003, citing breach of contract, Cenark reportedly sued CWS for "\$1.2 million-plus." *See Randy Kemp, Smith sues CWS for \$1.2 million, The Heber Springs Sun-Times, January 30, 2004.*

of agency law, actions by executive officers are imputed to the executive's company. *See Weeks v. United States*, 245 U.S. 618, 623 (1918). Mr. Smith held an executive position at CWS and apparently had authority to employ and commit to payment of outside vendors. Therefore, if CWS reimbursed political contributions in 2002 through the actions of Greg Smith, his section 441f violations are imputed to CWS under an agency theory. As a corporation, CWS would also be liable for making prohibited contributions pursuant to 2 U.S.C. § 441b(a), if Ms. Davis' allegations are borne out.

FEC disclosure reports indicate that Gill Law Firm attorneys Heartsill Ragon III, Charles C. Owen and Chris Travis made contributions to Marion Berry for Congress and Tim Hutchinson for Senate in August 2002, collectively totaling \$4,000.¹⁴ These contributions are consistent with Ms. Davis' allegation that Greg Smith instructed Mr. Ragon on July 15, 2002 to submit invoices totaling \$4,000 for reimbursements of political contributions. Further, it appears that the Gill Law Firm's July and August 2002 invoices were the mechanisms by which the Gill Law Firm attorneys may have been reimbursed for their respective contributions. As discussed previously, the Gill Law Firm's original July 29, 2002 invoice that describes a \$2,000 expense as "miscellaneous reimbursements" was allegedly "corrected," on Greg Smith's instructions, to read "series of intraoffice conferences re: various long-term planning, finance and operational issues." Although the Gill Law Firm August 29, 2002 invoice does not include a similar "miscellaneous reimbursements" entry, Ms. Davis' memorandum suggests that a prior copy may have contained such language. The timing of Mr. Travis' and Mr. Owen's contributions, and the fact that the

¹⁴ Mr. Ragon is reported as contributing \$1,000 to each committee; Mr. Travis is reported as contributing \$1,000 to the Berry committee; and Mr. Owen is reported as contributing \$1,000 to the Hutchinson committee.

\$4,000 contributed by Gill Law Firm attorneys matches the amount of the firm's invoice to CWS, raise substantial questions about the Travis and Owen contributions.

As discussed previously, the Commission believes that Charles McLaughlin is the "Charlie" named by Ms. Davis as another person that Greg Smith brought into the alleged scheme, although the possible reimbursement mechanisms are not precisely known at this time. *See discussion supra.* In 2002, Mr. McLaughlin and his wife, Cora McLaughlin, are reported as collectively making contributions totaling \$4,000. Mr. McLaughlin is reported as contributing \$1,000 each to the Berry committee, the Hutchinson committee, and on September 9, 2002, to the "Hutchinson and Arkansas Victory Committee," an apparent joint fundraising committee. Mrs. McLaughlin is reported as contributing \$1,000 to the Berry committee. These contributions are consistent with Ms. Davis' allegation that on July 15, 2002 Greg Smith requested "Charlie" to submit invoices to CWS for \$4,000.

Further, CWS board member Barbara Sullivan has made statements to the media suggesting that the scope of the reimbursement scheme may exceed \$20,000 in reimbursed contributions. *See discussion supra.* FEC disclosure reports indicate the alleged reimbursement scheme may have extended to other potential conduits making contributions to the Berry and Hutchinson campaigns in 2002. Luke Quinn,¹⁵ Danny Roberson,¹⁶ and Sharon Smith (the spouse of Greg Smith), individuals with apparent ties to CWS or CWS personnel, are reported as contributing \$1,000, \$500 and \$1,000, respectively, to the Berry committee and again to the

¹⁵ Dun and Bradstreet reports identify Luke Quinn as the President of Quinn Companies, Inc., an entity that also may have been a participant in the Lonoke-White Project at the time the contributions at issue were made. *Id.*

¹⁶ Dun and Bradstreet reports identify Danny Roberson as the owner of Roberson Land Surveying and Mapping, Inc., an entity that appears to have been a participant in the Lonoke-White Project at the time that the contributions at issue were made.

Hutchinson committee on the same dates as the Heartsill Ragon III and Charles McLaughlin contributions. With the exception of Sharon Smith, documents in the Commission's possession contain the names of these individuals in connection with Mr. Smith's political fundraising activities. In this overall context, it is possible that these individuals may have been reimbursed by CWS for one or more of their contributions.

Additionally, Mr. Smith may have directly used CWS funds to pay for at least one fundraising event in 2000. Specifically, according to press reports, on September 29, 2000, Mr. Smith used a CWS credit card to pay for \$165.13 in meals for a Congressman Berry fundraiser. *See* Elisa Crouch, *Waterline Project Beset by Conflicts over Management*, The Arkansas Democrat Gazette, March 2, 2003. Mr. Smith reportedly then used money from the Lonoke-White project to reimburse CWS's operating fund, which paid the credit card bill. *Id.* If these facts are true, CWS made a prohibited corporate in-kind contribution to the Berry campaign in violation of 2 U.S.C. § 441b(a).

As discussed *supra*, knowing and willful activity can be shown by an elaborate scheme to disguise corporate political contributions. *See United States v. Hopkins*, 916 F.2d 207, 214-15 (5th Cir. 1990). Ms. Davis alleges that Greg Smith instructed Heartsill Ragon III and Charles McLaughlin to submit false invoices to CWS to reimburse them for making contributions to federal candidates, and that they did so. This allegation, if proven, would represent an elaborate scheme to disguise CWS's corporate reimbursements of political contributions, and CWS, through the actions of Greg Smith, would have derivative knowing and willful liability.

Therefore, there is reason to believe that Community Water System, Inc. knowingly and willfully violated 2 U.S.C. § 441b(a) and 2 U.S.C. § 441f.